



Radical birthday thoughts

Jun 26th 2003 From The Economist print edition



Our happy 160th anniversary is an unhappy time for capitalism, writes Bill Emmott, editor of The Economist

WHEN a Scottish businessman named James Wilson founded *The Economist* 160 years ago this summer, he used the conventional means of circulating a <u>prospectus</u>. Yet the prospectus itself was far from conventional. It did include a two-page list of the sort of articles his new publication could be expected to carry, and even a plan for the first 13 weekly editions (issue six was to be led by an article on "Free trade and the national debt"; issue ten with one on "Widow Biddle and the poor needle-women of the metropolis"). But the rest of the document consisted of a single, 14-page article, a polemical essay about the economic, social and political benefits of free trade. This 19th-century equivalent to one of today's surveys in *The Economist* began with a lament:

It is one of the most melancholy reflections of the present day, that while wealth and capital have been rapidly increasing, while science and art have been working the most surprising miracles in aid of the human family, and while morality, intelligence, and civilisation have been rapidly extending on all hands;—that at this time, the great material interests of the higher and middle classes, and the physical condition of the labouring and industrial classes, are more and more marked by characters of uncertainty and insecurity.

Plus ça change, you might say; such words could easily have been written today, especially given that economic and technological progress seems at present to be held hostage by the uncertainties and insecurities of war, terrorism and other destabilising forces. The remedy advocated by Wilson, later reinforced by his eloquent son-in-law and successor-but-one as editor, Walter Bagehot, was liberty, particularly commercial liberty: restrictions to trade and free enterprise tended, he said, "to raise up barriers to intercourse, jealousies, animosities, and heartburnings between individuals and classes in this country, and again between this country and all others." The Economist today, just as in 1843, stands four-square against heartburnings and for uninhibited

intercourse.

The situation now, however, is different in a way that would bring delight to Wilson's eyes—and a feverish flow from his pen. In 1843, he was launching his newspaper at a time of entrenched protectionism, symbolised by the hated "corn laws" which restricted imports of foodstuffs and so raised the cost of living. He, and other likeminded liberals, wanted to bring a bad era to an end and to open up new possibilities. By contrast today, in 2003, the cause of liberal capitalism and poverty reduction has just had its best few decades in the whole of history.

In both periods, the consequences of a technologically driven mania cast a shadow over politics and economics: now, it is the bust following the boom of the "new economy" of information technology and the internet; in *The Economist*'s first decade it was the bust following the boom of the railways (a "headlong folly into which the country was then plunging", in Wilson's words, in the pursuit of quick riches and in defiance of economics). But in the 1840s the main task, amid the mania, was to try to get the doors of liberty open in the first place. Now the doors have at last swung thankfully wide. The task is to keep them open.

Pressure is growing to push them closed again—or, at least, to stop them from opening any wider. That pressure has many causes. Economic crises in the poor world have reminded people of capitalism's inherent instability. Unemployment in the rich world has reminded people of its inherent tendency to create inequality and of the disruptive effect on existing jobs when poor countries such as China or India succeed in growing richer. Political tensions between America and Europe as well as between the few rich countries and the many poor, especially (though not only) in Muslim countries, lead many to doubt whether further international integration is viable. Some blame globalisation, some a lack of democratic control; others hope and pray that liberal capitalism has had its time in the sun and that now something else will be tried.

There is no clear, coherent case being presented for a retreat from liberalism. But protectionism and other forms of government intervention do not necessarily require a coherent case if they are to succeed. They prosper when ad hoc political alliances can be formed between interest groups that stand to benefit directly and people or politicians who are simply angry about something or other; and when the forces and arguments for maintaining freedom are themselves weakened, incoherent or unpopular. And they can succeed step by debilitating step, rather than in one big triumph.

If protectionism does prosper again in that way, it will be a shame for the rich world but a tragedy for the poorer countries, for it would choke off their best hope of raising their living standards and of defeating poverty. Could it happen? It is not the likeliest outcome, which, as usual, is some sort of muddling along. But it is now a worryingly plausible one. And if it comes to pass, the principal culprit, the tipper of the balance, is likely to be the abuse in recent years in the rich countries of both capitalism and democracy that coincided with, and was greatly reinforced by, the "new economy" boom of the late 1990s. For that widespread and quite outrageous abuse, by

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capitalists, of capitalism, threatens to weaken the forces and arguments that would otherwise defend liberty. The danger exists everywhere in the developed world, but it matters most in the United States.

In his essay, Wilson pointed out that, during its 19th-century heyday, "The policy of England looked up to by all the world as the highway to greatness, was eagerly followed in her commercial regulations by other countries." The same is true today of the United States, and not just in matters of commerce. This survey will, like its predecessor 160 years ago, be a polemical essay in favour of liberalism but also against the abuse of capitalism and of democracy in the country that is seen—especially by itself—as the highway to greatness. First, though, some cheerier observations, to show what is at stake.





SURVEY

Liberty's great advance

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Liberalism has brought sharp reductions in both poverty and international inequality

THE past half-century can be seen as a long exploration of the power of liberal trade to raise living standards, not only in the rich world but among the poor too. It has also, more recently, been an exploration of people's preference, when given the choice, for democracy. The process is lamentably patchy and far from complete. Still, it has been an extraordinary success which holds great promise for the future.

The story begins with the growth that took place in western Europe, North America, Australasia and Japan once the two great scourges of economic activity—war and trade restrictions—were removed after 1945. These countries were the main signatories of the General Agreement on Tariffs and Trade in 1947 (Japan joined in 1955), which began the process of dismantling trade barriers. That group, subsequently known as "the West", increased its income per head fourfold in 1950-2001, a growth rate averaging 2.8% a year. Chart 1 shows how world GDP growth, led by the West, came to be associated with even faster growth in world trade.



The rest of the world—communist, socialist, or just plain poor—also grew, but more slowly: at 2.2% a year on average, or a threefold rise in income per head. Thus the gap between "the West and the rest", as Angus Maddison, an economic historian, described it in an OECD report in 2002 from which these figures are taken, has been widening. It is now especially wide between the richest few countries in the world and the poorest few, which are mainly in Africa; wider, indeed, than ever before. Sceptics about trade use such increases in global inequality as evidence that under liberalism the rich get richer and the poor stay poor. Yet that is wrong.

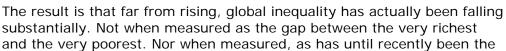
Such broad figures disguise the underlying trends. These are that countries in Asia have actually been narrowing the gap substantially: there, excluding already-developed Japan, in 1950-2001 income per head increased fivefold. In the early decades, Asian growth could be dismissed as exceptional, given that it was limited mainly to the city states of Hong Kong and Singapore, and two politically anomalous countries, Taiwan and South Korea. But since 1980, not only has growth spread to South-East Asia but it has also accelerated in the world's most populous countries, China and India. Given that Asia as a whole is home to well over half of the world's people, such progress can no longer be dismissed.

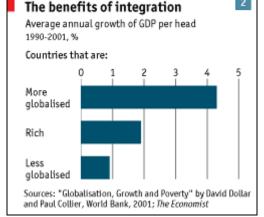
An open secret

The countries that have succeeded in raising living standards rapidly, over long periods, have followed many varieties of economic policy and have lived under many different forms of government. What they have had in common, though, has been a policy of opening their economies to trade and to foreign capital. Not fully, or even nearly so: none, except perhaps tiny Hong Kong, has followed the laisser-faire formula demonised by antiglobalists (which, incidentally, America has not followed either). Nor have they grown by somehow promoting exports and blocking all imports. Rather, they liberalised some markets in order to stimulate competition, internally and from imports; and they ensured that imports of most basic commodities and components faced

few barriers, in order to keep prices down for the users of such goods. They adopted liberal trade partially, selectively and mostly gradually. But the important thing was that they adopted it.

Chart 2 shows the World Bank's depiction of the effects of such policies since 1990, a period during which the move away from closed, centrally planned economies became a rush, following the fall of the Soviet Union in 1991. Countries that have opened their borders in this way have seen their incomes per head grow rapidly—much more rapidly than either the existing rich countries or those that have not globalised, either by choice or through lack of opportunity. There have been failures, most notably in the former Soviet Union, where Russia and its nearest neighbours, Ukraine and Belarus, suffered economic decline in the 1990s even when they did liberalise some markets; and most recently in Argentina where a fixed exchange rate combined with fiscal profligacy led to disaster. But such failures are heavily outweighed by the successes.





rather odd norm, as the difference between the average incomes of each country, regardless of population (thus counting Chad and China as if they were of equal size). But if it is measured in the way which is normal within countries, as the distribution of individual incomes, it has narrowed considerably. Given the rapid growth in China over the past 20 years, and the less rapid but still healthy growth in India, that observation makes eminent sense: huge chunks of the world's population have been climbing out of poverty. Even so, it is controversial.

Such things are, admittedly, hard to measure. There is no worldwide census of everyone's individual income, so indirect routes must be used to estimate it. But two different studies, using different methods, have now come up with broadly the same conclusion. One, by Xavier Sala-i-Martin of New York's Columbia University for America's National Bureau of Economic Research, is depicted in chart 3: it shows how rising incomes, especially in Asia, are creating what, in world terms, could be described as a huge middle class. As the bulge moves to the right of the chart, so incomes are becoming more equal.

Far from rising, global inequality has actually been falling substantially

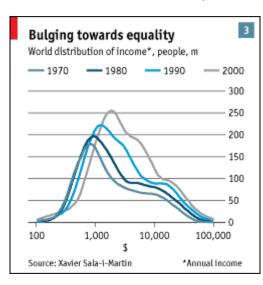
Another study, by an Indian economist named Surjit Bhalla, in a book for the Institute for International Economics called "Imagine There's No Country", confirmed those findings as well as the consequent drop in world poverty. Measured by the benchmark favoured by the World Bank of income of \$2 a day or less, adjusted to cater for differences in purchasing power, the proportion of the world's population in poverty dropped from 56% in 1980 to 23% in 2000, on Mr Bhalla's calculations. Thanks to population growth, the absolute number of people in that category remains large: more than 1.1 billion. But that is still far fewer than in 1990 (1.7 billion) and 1980 (1.9 billion). Before 1980, the absolute numbers were rising. That date roughly coincides with the spread of trade and internal-market liberalisation to many poor countries.

The truth about market liberalisation and economic growth is not that it increases inequality, nor that it hurts the poor: just the opposite. Rather, the truth is that some large parts of the poor world are pulling themselves out of poverty while others are not. Those poorer parts include some countries in Asia, including Pakistan and Central Asia, and some in Latin America as well as most of the Middle East, where liberalisation has scarcely been attempted and revenues from oil have lately declined. Most notably, though, they include more or less a whole continent, namely Africa. There, incomes have stagnated or even declined, and life expectancies are falling too, thanks to AIDS and other plagues. Home to 13% of the world's population, the continent accounts for merely 3% of world GDP. The lack of progress in Africa, not the supposed evils of globalisation, is where the most difficult problem of economic

development lies.

Democracy too

Alongside this successful growth in economic liberty, there has also been an impressive expansion of political and civil freedoms. Since 1980, according to the 2002 United Nations Human Development Report (UNHDR), 81 countries have taken "significant" steps towards democracy, with 33 military regimes replaced by civilian governments. Of the world's nearly 200 countries, 140 now hold multi-party elections. That may not make them fully democratic, but 82 of them are, and those are home to 57% of the world's population. Especially pleasing to an independent organ such as *The Economist* is the fact that, according to the UNHDR, 125 countries, with 62% of the world's population, now have a free or partly free press. The spread of daily newspapers in developing countries



has risen to 60 copies per 1,000 people, from 29 in 1970-96, and the number of televisions has increased 16-fold.

Recently, it has become fashionable to play down that progress by pointing out that many of the new democracies have not gone beyond elections to build the other, essential, protections for liberty: an independent judiciary, equality before a well-enforced rule of law, and constitutional limits on the abuse of political power. In Zimbabwe, an elected president, Robert Mugabe, has ruined the country, sponsored violence and rigged elections. Constitutions have been violated by elected politicians in Peru and Russia, and judiciaries manipulated. Venezuela's elected president, Hugo Chavez, essentially wrote his own constitution, which he hands out to visitors as a little blue book reminiscent of Mao Zedong's red one.

In sub-Saharan Africa, according to "The Future of Freedom", a new book by Fareed Zakaria that wrings its hands about "illiberal democracy", 42 out of 48 countries have held multi-party elections since 1990, but most have simply allowed a rotation of plundering governments. A few democracies have even collapsed: Pakistan's elected government was overturned in a coup in 1999 by General (now self-appointed President) Pervez Musharraf.

Such worries are perfectly fair. Much more progress is needed. It would be wrong to celebrate the mere holding of elections if other, arguably even more important, protections for liberty are not present or likely soon to be created. Some democracies, including long-standing ones such as Malaysia and Singapore, essentially have semi-authoritarian regimes. Yet such legitimate concerns should not be allowed to detract from the basic progress that has occurred: in the past 20 years the share of the world's population living in proper democracies has risen from about a third to just over half. Freedom House, a Washington-based think-tank, this year rated 89 countries as being "free societies", up from 75 in 1993, and a further 55 as "partly free". Liberty has had a period of tremendous advance on all fronts.

In the short term, there is cause for optimism that this advance will continue. Despite economic crises in East Asia, Russia and Latin America during the past six years, developing countries still seem to want to liberalise their economies. China has recently joined the World Trade Organisation, bringing the total membership to 146 countries, and Russia is in the queue for membership, along with 25 others. After shrinking slightly in 2001, the volume of world trade started to grow again in 2002, albeit weakly. Efforts have begun to try to implant democracy in Afghanistan and Iraq. Argentina has endured an economic collapse to match the Great Depression of the 1930s, yet has emerged with its democracy intact.

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Liberty's next retreat?

For all the anti-globalists' cries on their behalf, few of the world's poorer countries show signs of wanting to

retreat from liberalism: their question, rather, is whether to extend it rapidly or gradually, and whether they have the domestic governmental institutions to be able to cope with it. Though it does little to promote democracy, China is proving a spur to economic liberalisation in other developing countries: fear that its growth will steal their markets or investment is prompting others to copy its reforms and to adopt international trade rules by joining the WTO. The real doubts are in the pioneers of globalisation, the rich countries.

Business is under attack, even in the homeland of free enterprise, the United States, whether from politicians, single-issue lobby groups or, most dangerously of all, from lawyers. Having made pots of cash from tobacco firms, they are turning their attention to Wall Street and to drug companies. Anti-capitalist demonstrations on May 1st in cities around the world attracted sizeable crowds. Stockmarkets remain weak, despite a quick end to the war in Iraq and a 30% fall in oil prices. So do many economies, especially the biggest and richest ones in western Europe, Japan and the United States.

Plus ça change, once again? Wherever democracy allows a crowd to gather, there will always be some who resent the selfishness inherent in the profit motive, or who stand to lose from the change that economic and technological progress or the evolution of tastes may bring, or who simply like a good march and love to yell abuse at the high and mighty. With the economic, social and even environmental failure of communism and its milder comrade, socialism, still fresh in the memory, there is little chance that any alternative to a capitalist economy could soon garner widespread support. And

There is always anxiety that the good times may never return. Yet they always do

whenever economies approach the bottom of their inevitable cycles, there is always anxiety that the good times may never return. Yet they always do.

There are, though, some stronger reasons to worry. One, admittedly, is generic to all bad times: the fact that it is when unemployment is rising, or incomes are falling, or prospects seem dim, or threats of war and terrorism spread fear and anger, that politicians come under the greatest pressure—and temptation—to close borders or to slap controls on freedoms of all kinds, whether civil or commercial. They may wish to curry favour with domestic lobbies or merely to look as if they are doing something.

Another reason, however, is peculiar to today and risks greatly amplifying the generic one. It is that the economic and financial-market boom of the 1990s was so extreme that its bust is also producing extreme results: a pile of corporate scandals, resentment at an extraordinary widening of inequalities of income and wealth within the rich countries, a ghastly hole in the retirement funds of millions of ordinary people and, most crucially of all, a gathering disillusion about the ability of democratic institutions to hold culprits accountable for their sins.

A long way to fall

Such results can be seen, in some measure, right across the developed world. But they are at their most noticeable in the United States, for that is where the 1990s boom, along with its extremes of misbehaviour, went the furthest. In the title of a feisty and well-researched book by a commentator and political activist, Arianna Huffington, in America in recent years there were "Pigs at the Trough", extracting gigantic executive salaries and perks, faking corporate accounts, manipulating equity offerings and granting each other vast piles of share options, among other abuses. More outrageously still, many of those benefiting from this flow of cash managed successfully to lobby Congress and the White House to reject reforms that could have stemmed some of the abuse.

When such excesses have occurred in the past, there has been a political backlash to exploit the popular anger, as under the presidencies of Teddy Roosevelt and Woodrow Wilson in the 1900s. That remains a strong possibility, even though the popularity of the famously pro-business President George Bush is running high, thanks to the wars on terror and Saddam Hussein. The danger is often expressed as one of an over-reaction to the excesses, of an excessive bout of regulation on business. That danger exists; but the worst possibility is that anger at capitalist abuses will tip the balance in domestic politics towards protectionism, as a misguided way to help the weak and vulnerable, and to pander to suspicion of markets and business. If it does, remember to blame those pigs and their love of the trough.



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Pigs, pay and power

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At the heart of capitalism's troubles lies executive pay

THE litany of scandals is by now familiar. Around the globe, Enron and WorldCom are household names, and who will soon forget the \$15,000 umbrella stand bought for Tyco's already extravagantly paid boss, Dennis Kozlowski, with his employer's money? In America there are also Adelphia, HealthSouth, ImClone, Global Crossing, Xerox, Qwest, the hundreds of public companies that re-stated their accounts in recent years and the Wall Street investment banks accused of conflicts of interest and shady practices.

In Europe there are the false accounts of Royal Ahold, a large Dutch food distributor and retailer, the controversial payments to the German bosses of Mannesmann when they accepted Vodafone's takeover bid in 2000, the troubles of Vivendi in France and Marconi in Britain, and the bribery and other legal cases surrounding Italy's richest businessman, Silvio Berlusconi, who happens also to be its current prime minister. In Japan, ever since the stockmarket crashed in 1990 there has been a steady flow of corporate and banking scandals, over perks or cover-ups or huge debts or simple incompetence.

Is this not proof that markets cannot be allowed to rampage freely, driven as they are by greed? Well, much of this mess is cyclical, the sort of thing that happens whenever bust follows boom. As Alan Greenspan, the chairman of America's Federal Reserve, has said, in the 1990s there was no increase in human greed, just an increase in the opportunities for greedy behaviour. Japan's experience, though, following its share and property bubble in the late 1980s, is that cleaning up the mess can take a long time and a strong stomach—and that vested interests in continued corruption can delay or even prevent the clean-up.

On that analysis, the basic task is to ensure that existing laws are vigorously enforced and that any loopholes in them are closed—much more rapidly than Japan has managed. The sight of once-high-flying executives being carted off to jail ought, as in previous periods of scandal, to deter wrong-doers for a time. In America, the process is proving a little slow, but it is under way and is certainly outpacing the Japanese precedent. The table

shows the progress so far in enforcing laws and tightening them up.

The problem does not, however, stop there, because a large part of it is structural, not merely cyclical. And that part has less to do with law enforcement and more to do with the way companies are owned and run. Levels of executive pay symbolise the issue, for they show what has occurred entirely legally. Those who attack pay levels are often accused of "the politics of envy", or of failing to recognise the role of incentives. That is unfair. It is better thought of as the politics of astonishment, a tale of misdirected incentives and misdelegated power.

Golden carrots

How big a gap should there be between the pay of an ordinary worker and that of the top executives? Once upon a time, a popular benchmark was that the boss should be paid no more than about 20-30 times the level of a lowly toiler. In America the gap has long been larger than that, though not outlandishly so. According to *Fortune* magazine, in 1970 real annual compensation averaged \$1.3m (in today's money) for the top 100 chief executives, which was about 39 times the pay of an average worker. By the end of the 1990s, however, the average for *Fortune*'s top 100 was \$37.5m, or 1,000 times the level for ordinary workers.

Company	Primary allegations ¹	Alleged culprits ²	Investigators	Legal proceedings	Purishment	
Enron	Fraudulently inflated financial results; conspiracy; money laundering	CFO, CEOs, SEs	SEC, JD, C	Grand-jury indictments; continuing investigations ³	Assets of CFD frozen	
WorldCom	Fraud; improper profiting from IPOs; inappropriate company loans; conspiracy	CFO, CEO, CT, SEs	SEC, MYSAG, JD, C	Investigations continuing; trials expected early 2004 ⁴	\$500m company settlement with SEC on civil-fraud charges	
Xerox	Fraudulently inflated financial results to profit from bonuses and stock sales	CEO, CFO, SEs	SEC, JD	3D investigation continuing	\$22m settlement with SEC on civil-fraud charges ⁵	
Adelphia	Fraud; misuse of corporate funds by founding family	CEO, CFO, SEs	SEC, JD	Charges brought; trial expected early 2004 ⁶	-	
Tyco	Tax evasion; misuse of company funds to inflate stock-value; inappropriate company loans	CEO, CFO, CLO	SEC, MDA	Charges brought; trial expected 2003	-	
ImClone	Insider trading; tax evasion; obstructing justice	CEO, Martha Stewart	SEC, JD, C	CEO pleaded guilty to some charges	7 years' imprisonment; \$3m fine	
Qwest	Improperly profited from IPOs; fraudulently inflated financial results	CED, CM, SEs	SEC, NYSAG, JD, C	Charges brought	CM has reached \$4.4m settlemen with NYSAG on IPO charges ⁵	
Global Crossing	Fraudulently inflated financial results; cashed in stock just before bankruptcy	CM	SEC, JD, C	SEC investigation continuing; JD investigation brought no charges	-	
HealthSouth	Fraudulently inflated financial results; conspiracy	CEO, CFOs, SEs	SEC, JD, C	Charges brought; investigations continuing ^T	-	
Ahold	False declaration of pre-tax profits	CEO, CFO, CLO, SEs ⁸	Ahold Internal review, SEC, JD	Probes, no charges brought as yet	-	
Investment banks	Abuse of conflicts of interest	12 Wall Street firms	NYSAG, SEC, C	Investigation concluded April 2003	\$1.4bn combined settlement	
	CEO-Chief Executive Officer. CFO-Chief Financial Offi ating agencies: SEC-Securities and Exchange Commis	ssion. JD-Justice Departn	nent, C-Congress, N	YSAG-New York State Attorney General.		
	1. In general; in som 3. One SE has pleade: Defendant/s neither admitted nor denied wrongdoing	d guffity to money launder	fing and fraud, but i	or around, the time scandal broke. Most not yet sentenced 4. Several SEs have	pleaded guilty to conspiracy and fr	

Much of the explosion in the pay of top executives was accounted for by grants in shares and (especially) share options, which soared in value during the stockmarket bubble. Share prices have slumped since mid-2001, so has executive pay slumped too? Not exactly. Admittedly, the days when massive, jaw-dropping sums were taken by a few stars—Michael Eisner of Disney, Larry Ellison of Oracle—have gone. *Business Week*'s annual survey of the pay of America's 365 top bosses showed that the highest-paid executive in 2002, the late Alfred Lerner of MBNA bank, took a mere \$194.9m, much less than the 2001 winner, Mr Ellison, who got \$706.1m. Thanks to fewer such huge cash-ins, the average package for the 365 fell by a third to \$7.4m. But the median pay actually rose by 5.9% to \$3.7m.

In Britain, although pay levels are lower, there has been a similar process of inflation, partly under America's influence. And British executive pay has also been remarkably resilient in the face of the stockmarket's slide and of a domestic economic slowdown. A research firm, Incomes Data Services, reported in May that the basic pay of chief executives at FT-SE 100 companies rose by an average of 11.2% in 2002 and their overall earnings rose by an astonishing 23%.

The longer-term result, most noticeably in America, has been a rapid increase in incomes at the top end of the scale. Inequality as a whole has been gradually increasing for two decades, a trend generally attributed to the

effects of technological change on the wages of unskilled workers. But there has also been a concentration of big gains in income and wealth for the top 1%, and within that for the top 0.1% or even 0.01%. Estimates quoted by Paul Krugman, a Princeton economist, in the *New York Times Magazine* last October showed that as of 1998, the latest figures available, the top 0.01%, a mere 13,000 taxpayers, received more than 3% of all income in America. Those 13,000, which will have included rich share-owning families, mega-entrepreneurs such as Bill Gates and many of the top executives featured in *Business Week*'s survey, then had an income of at least \$3.6m and an average income of \$17m. In the following few years, those figures will have ballooned even more, before sagging in 2001-02.

Does this matter? Not as such. The extremes of wealth are so remote from the lives of ordinary people that they rarely have a political impact. And America has long been much more tolerant of unequal incomes and wealth than have other countries, many of which were politically sensitised by a history of hereditary aristocracy. As long as people have felt that most of the rich earn their wealth on merit, or at least without abuse of power, and that it remains possible for ordinary people to join their ranks, inequality has mattered little. But there lies the crucial point. The really damaging perception now is that many of these mega-incomes have been gained through the abuse of power—and that, in some cases, they are also being preserved by the use of that moneyed power in politics. Worse still, the perception is largely correct.

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Egalitarians v plutocrats

Broadly, there were two contradictory trends in Anglo-American corporate culture during the 1990s. One, which grabbed the imagination during the internet boom, could be called egalitarian: it became fashionable to spread ownership widely around a company by issuing shares and share options, hierarchies were flattened, dress codes torn up and workplaces made livelier with fish-tanks, scooters and pizza. The other, though, amounted to plutocratisation: managers' interests were to be aligned with those of shareholders through options and other performance-related pay in order to ensure that companies were run to maximise "shareholder value", but that alignment was to be concentrated on the few at the top who could really "make a difference".

A recent book, "In the Company of Owners", by Joseph Blasi, Douglas Kruse and Aaron Bernstein, tracked the difference between these two approaches. Egalitarianism has mainly been a feature of high-tech firms, though not only of start-ups: the authors compiled figures on 100 big high-tech firms and found that on average employees owned 33% of those companies' equity, of which 14% was held by the top managers and 19% by other employees. Microsoft, for example, has enriched Mr Gates and his top managers hugely, but it has also created thousands of millionaires among its employees.

The book compared that list with a sample of 100 large traditional firms listed on the New York Stock Exchange. There, top managers also owned 14% of the equity on average, but other employees held a mere 2%. Moreover, this was more typical across the whole economy. Although the open-necked shirts of egalitarianism hogged magazine covers during the internet boom, plutocratisation was actually the dominant trend.

This was not much noticed at first, despite the hoopla about aligning interests and creating value for shareholders, because quite a lot of the plutocrats' pay was hidden. Stock options did not have to be counted as expenses in companies' profit-and-loss accounts, and their value did not become apparent until they were exercised. Boards also lent executives huge sums of money, sometimes to buy shares in their firms but often with no specified purpose, and repayments were later waived. A lot of pay was deferred, in the form of lavish pension schemes confined to top executives. And the divorce proceedings of Jack Welch, the long-time chief executive of General Electric, showed that commitments were made to carry on providing perks to bosses well after their retirements, such as the use of corporate jets and ritzy apartments. Robert Monks, a private investor and shareholder activist, has aptly described all this as "stealth compensation".

Why did it happen? One answer is that it is just the market at work, a market for top executives in which demand is high and supply limited. A typical riposte is that the market is rigged: pay is set by board committees comprised of other chief executives or friendly directors dependent on the chairman, advised by pay consultancies hired by the managers themselves. Both are true: pay, stealthy or overt, has been bid up between

companies, making it hard for individual firms to jump off the pay escalator even if they wanted to (which few did). That is also why there has been no link between pay and performance: lacklustre firms followed the escalator too, perhaps in order to attract good managers, or out of pride, or because their shareholders failed to prevent it.

Yet the fact that this is a market outcome does not sanctify the result. It is a market driven by conflicts of interest, swelled by covert deals and protected by successful lobbying to prevent stock options from having to be accounted for as an expense, hurting reported earnings. And it has reached into the heart of government. John Snow, who is now President Bush's treasury secretary, was previously a notably well-paid boss of a notably under-performing railway company, CSX. In 1997-2001 he was

The fact that this is a market outcome does not sanctify the result

paid a total of \$37.4m, according to the Corporate Library, a governance-monitoring service. He also had a Jack Welch-style post-retirement deal giving him jets, country clubs and cars. Nor was he just a lucky, passive recipient. In 1994, when he chaired the Business Roundtable, that body of big-firm chief executives lobbied the Senate to rule that options should not be treated as costs. The Senate obliged by 88 votes to nine.

These high earners drove their own pay inflation and protected it with their corporate and personal political lobbying. But how did they get the power to do so? The answer is that shareholders gave it to them, voluntarily.

The New Hork Times



SURVEY

Beyond shareholder value

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Shareholder capitalism suffers from a vacuum of ownership

ANY organisation—a company, a government ministry, a charity, the local golf club—tends to become inward-looking if there is too little external discipline. Reams of academic literature have been produced to show how civil servants, however good-hearted, naturally act in their own interests, boosting their budgets, protecting their power, resisting outside scrutiny. So it is in private companies, except that managers there face discipline from competition with other firms, from the need to satisfy customers and from the demands of shareholders. Competition and pressure from customers have both become a lot more intense in most industries in the past two decades, all over the world, with beneficial effects on productivity and innovation. Pressure from shareholders, however, has not.

On the face of it, that looks an implausible claim. During the 1980s the rise of hostile takeover bids and leveraged buy-outs (LBOs) made bosses on both sides of the Atlantic keen to suck up to shareholders. Since then, chief executives have had to spend lots of their time talking to share analysts and big institutional investors to manage perceptions of their firm in the financial markets. The mantra in both America and Britain, followed by the more international firms in continental Europe too, has been that firms should be managed to create "shareholder value"—ie, rising share prices and/or dividends.

To add to the discipline, it has been assumed in Anglo-American capitalism that executives should earn bonuses tied to performance targets that bring value to shareholders; and, to align the interests even more securely, should themselves own chunks of stock and stock options. That trend took hold during the 1980s, encouraged especially by a study in 1976 by Michael Jensen, at the Harvard Business School, and William Meckling, of the University of Rochester, which explained how the interests of managers and owners had diverged, leading to slack corporate behaviour. This is not a new phenomenon. Messrs Jensen and Meckling quoted Adam Smith's 18th-century view on the same "agency problem":

The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot be well expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Negligence and profusion, therefore, must always prevail.

Professor Jensen's solution, then and in later studies, was to make managers act like owners by tying their http://www.economist.com/printedition/PrinterFriendly.cfm?Story_ID=1857649 7/27/2003

incomes to profits or the firm's overall value, and to use large debts (especially through LBOs) as a further external discipline. What happened during the 1990s, however, was somewhat different, increasingly so as the decade went on.

Part of the reason was circumstantial: after a short-lived but scary crash in 1987, share prices rose almost continuously for 13 years. This meant that "shareholder value" became hard to separate from the general market rise, and that shareholders could afford to be indifferent both to mediocre relative performance and extravagant executive pay. It meant that equity capital became abundant, and the discipline of LBOs and debt disappeared. Mergers and acquisitions roared ahead, but acquirers learned to be friendlier to the managers of firms they bought, providing big pay-offs.

The bull market also meant that shares and share options granted by boards to top executives often proved a lot more generous than initially expected: some of the new wealth came simply as a windfall as share prices soared. So extravagant pay was not entirely the boards' fault. But several other points should also be noted:

- Targets set as triggers for incentive payments came to suffer from what central bankers know as "Goodhart's law", after the academic who noted the phenomenon: any target that is set quickly loses its meaning as it comes to be manipulated.
- In any case, the setting of detailed performance targets, whether by boards or shareholders, is no easier in a private company than it used to be in the Soviet Union. The expertise required to fine-tune such targets, in the face of complex markets and organisations, is unattainable.
- However general or detailed the targets, the stockmarket's demand for smooth rises in quarterly earnings, combined with the frequent link between those earnings (or just the share-price movement) and bonus payments, provided a powerful incentive for manipulation.

Practice	Britain	Canada	France	Germany	Italy	Japan	United States
Auditors are independent from consultancy?	Recommended	Yes	Voluntary	No	Yes	Yes	Yes
Auditors are rotated?	Voluntary: 5-7 years	Yes: 7 years	No*	No	Yes: 9 years	Yes: 7 years	Yes**: 5 years
Shareholders vote on executive pay?	Advisory	Yes1	No	No	Yes4	Yes‡	No
Shareholders may elect own slate of independent directors?	No	No	No	No*	Yes	Yes	No
Independent directors in a majority on board?	Recommended	No	Voluntary [©]	Recommended	No	No	Yes
Expensing of stock options?	No	No	No	No	No	No	No*
Disclose value of options?	Yes	Yes	Yes	Recommended	Yes	Yes	Yes
Separate chairman and CEO?	Recommended	Voluntary	Voluntary	Yestt	Voluntary	Voluntary	Voluntary

- The auditors supposed to be monitoring such accounting reports were appointed by the managers themselves, and dependent on them not only for continued audit fees but also for even larger consultancy business.
- Remuneration packages were set by board committees with little influence from shareholders, who left chairmen to choose supposedly independent directors too. Without any pressure to tie pay to long-term corporate performance, it was naturally linked to quite short-term measures or to none at all. The rapid rise in share prices played its part by making options exercisable increasingly quickly.

Some of the extremes of the 1990s occurred because of law-breaking and manipulation. Much, though, occurred because owners allowed it to; they delegated their powers to managers, leaving them to set pay and targets, and to monitor their own performance.

"Owners" is perhaps the most misleading word in Anglo-American capitalism, for there are not many true owners. Most are, as Rupert Pennant-Rea wrote in a survey in *The Economist* in 1990, "punters, not proprietors". The vast majority of shareholders are either small retail investors, or huge pension funds, mutual funds and insurance firms that manage diversified holdings through investment managers—and those managers face conflicts of interest, for they live off mandates from companies to manage corporate pension funds and provide insurance. The only large shareholders free of such conflicts are public-sector pension funds. They, though, share a general inhibition

"Owners" is perhaps the most misleading word in Anglo-American capitalism

with other large investors: the benefits of active involvement in steering corporate boards are low whereas the costs are high. It has made much more economic sense to be passive not active, a punter not a proprietor.

The question now is whether this will change, given the slump in share prices and the scandals. Shareholders themselves are under pressure, and the gigantic holes now appearing in corporate pension funds could give them a joint interest with managements in forcing change and boosting genuine earnings over the longer term. The deficits in funds offering "defined benefits" (ie, pensions generally linked to employees' final salaries) are estimated by America's Pension Benefit Guaranty Corporation to total some \$300 billion. Those in big British companies may amount to around \$100 billion. A stockmarket recovery would reduce those figures, but it would take many years of high share returns to wipe out the deficits.

That pressure may produce some change, inducing more institutions to be active rather than passive owners. In Britain in particular, there has been a spate of shareholder revolts over bosses' pay (an annual "advisory" vote on which has become a legal requirement this year), culminating in the rejection on May 19th of GlaxoSmithKline's ridiculously over-generous contract terms for its chief executive in the event of severance (he stands to receive up to £22m, or \$36m).

It is also possible that LBOs and other ways to take companies out of the public stockmarkets may take the lead again, if equity capital remains scarce and the use of debt as a discipline returns to favour. Professor Jensen himself, along with other experts, has suggested better ways to tie executive pay to long-term performance: through "restricted stock" that cannot be sold for many years or, Professor Jensen's preference, special share options that require price appreciation to exceed a firm's cost of capital and are exercisable only after a long delay.

Such ideas are clever, no doubt, and might even work if implemented, making profits higher and more sustainable while bosses' pay becomes less outrageous. But they run up against two strong objections. One could be called simple complacency: although Anglo-American capitalism has become wayward in recent years, it has still fared quite well. As the Jensen and Meckling paper of 1976 concludes, "Whatever its shortcomings, the corporation has thus far survived the market test against potential alternatives." Scandal, in other words, will deal with the worst abuses, after which things can carry on pretty much as before. The other objection is that clever ideas are not enough: corporate boards will change their ways, particularly on pay, only if they are forced to. They can already design their own special options—ones that pay out a lot, and quickly—and will continue to do so.

There is some justification for the complacent view. But a political backlash against the abuse of pay and the resulting inequality, and a long-term loss of confidence in equity markets, are high risks to take. Given the chance, it would be more prudent to reform Anglo-American capitalism. How could it be done? Mainly by government and by self-regulatory agencies such as the big stock exchanges but also, to a degree, by shareholders themselves. The best analysis of what needs doing has been provided by Mr Monks, the active American investor, and Allen Sykes, a former senior British executive. In a paper last year for the Centre for the Study of Financial Innovation, a London-based think-tank, called "Capitalism Without Owners Will Fail", they identified the crucial issue as the vacuum of ownership, and argued that only governments can induce investing institutions to fill that vacuum by taking on some of the obligations of ownership. Once they do, the authors said, shareholders should then be able to experiment, in the market, to find the best ways of exerting such ownership.

Essentially, Messrs Monks and Sykes want governments to enforce existing trust law, which already requires fund managers and other fiduciaries to act solely in the interests of their beneficiaries. The difficult question is how. One method is already being employed, namely class-action lawsuits by beneficiaries against trustees; this

may increase, given the big fund deficits. Another, suggested by Messrs Monks and Sykes, is for governments to make it a legal requirement that institutions with holdings above a large minimum, say \$15m, should vote on company business. Such votes should be disclosed, so that beneficiaries can decide whether voting is being exercised in their sole interest. Further, Messrs Monks and Sykes want shareholders to have the right and obligation to nominate at least three independent directors for all big guoted companies.

These are good ideas. In addition, several important principles are much discussed but not always enforced:

- Monitors must not be allowed to be appointed by and dependent on those they monitor. So auditors should not also perform consultancy business for the firms they audit. That reform is being introduced in America. But in addition there ought to be a statutory requirement that auditing firms (not just the partners involved, as is now required) be changed, regularly.
- Independent directors should be genuinely independent. Friendships cannot be legislated against, but business ties, such as consultancy fees or supplier relationships, could be barred, either by law or by stock-exchange requirements.
- Boards combine a strategic purpose and a monitoring role. But shareholders are neglecting their duty to their beneficiaries if they allow the first to negate the second. They will be doing so if they allow non-independent directors to control executive remuneration or auditing, for example. Boards often complain that having stronger independent directors risks harming the unity of boards and weakening the authority of the chief executive or chairman. Just so: that should be the aim.
- Companies should not be in the business of providing pensions for their employees. It exposes them to risks, as today's big deficits have shown, as well as creating conflicts of interest with fund managers and shareholders. Yet tax breaks continue to induce them to run such schemes, or to goad employees to keep their pension plans heavily invested in the firm's shares—as was shown at Enron. Those incentives ought to be abolished.

Active ownership

If these proposals and principles were to be followed, shareholders ought then to be able to find their own ways of becoming active owners or at least of exercising their obligations. Claude Bébéar, for example, the head of Axa, a giant French insurance firm, has suggested in a recent book, "Ils Vont Tuer le Capitalisme" (They are going to kill capitalism), that not only should voting by shareholders be compulsory but also that companies should be allowed to give longer-term shareholders more voting power and/or higher dividends. Currently, this is forbidden by the convention (sometimes rule) that all shareholders in publicly listed companies should be treated equally.

As long as such arrangements are fully disclosed (as Mr Bébéar recommends), and freely voted upon in the first place, this seems a perfectly good idea to try. Provided that shareholders know what they are letting themselves in for when they buy shares, they should surely be allowed to have such differential voting powers—which are common enough in various forms of private company (such as The Economist Group). Other methods that may make active ownership more viable could include the use of new intermediaries paid to monitor, vote and even find directors, which after all is part of what private equity funds do already.

But is any of this likely to happen? Complacency, and a belief that capitalism can cope simply by muddling through, may prevent it. So, too, however, may governments' squeamishness about enforcing or even recommending things that businessmen don't like. In the more liberal era of the past 20 years governments have often been accused of being too devoted to markets. Actually, a more telling accusation is that they have been too devoted to business.

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SURVEY

Pro-market, not pro-business

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Governments should keep their distance from businesses and their bosses

THE critiques vary. Some British commentators allege that companies have taken over the role of government, creating a "Captive State" (in the title of a book by George Monbiot, a *Guardian* journalist) or have made a "Silent Takeover" of sovereignty (a book by Noreena Hertz, a Cambridge academic). Others simply think the free-market era was a "False Dawn" and is over (John Gray, of the London School of Economics). Americans have tended to focus on the role of lobbyists and political corruption ("Pigs at the Trough", by Arianna Huffington, cited earlier; "Government's End", by Jonathan Rauch, a columnist for the *National Journal* and formerly a writer for *The Economist*), or on the relationship between "Wealth and Democracy" (Kevin Phillips, a distinguished political writer). Or on the domination of the Bush administration by "big" or just "Texas" oil interests (too many critics to mention, of all nationalities).

Is there any truth to all this? One thing these critiques are not compatible with is the common notion that the nation state is dead, its powers handed over to markets by "fundamentalists" (ie, the deregulation and privatisation led by Ronald Reagan in America and Margaret Thatcher in Britain in the 1980s), or usurped by globalisation or supranational institutions (the European Union, the WTO, etc). For if the state had few powers left, it would not be worth capturing, bribing or otherwise suborning. But it has, and it is. Corruption, by firms and individuals seeking to exploit governments' vast powers, is indeed a big problem for democracies all over the world. Yet it is not the whole problem. Governments remain far too keen to do businessmen's bidding even when no money is offered.

Why, for example, have share options not been treated as a cost in corporate accounts, or taxed equally with other personal income? A partial answer is that doing so is not easy—the right price is difficult to determine, the cost is mainly one of dilution of existing shareholders' equity stakes rather than a direct cost to the firm, and the income is hard to evaluate until the options are exercised. If the will had been there, however, those hurdles could have been overcome. So the most tempting explanation for why nothing has been done, given America's political ways, is corporate lobbying larded with campaign donations. Corruption, in other words.

Yet this cannot be the whole answer, for options have been given special treatment elsewhere, too: Britain's Labour government maintained tax concessions for them without donations in return. Why? Because businesses told the government this would help high-tech companies to prosper. "Picking winners", the old delusion of British industrial policy, may have been obsolete, but if managers picked the winners for you, that made it all right.

Since Gordon Brown, Labour's chancellor of the exchequer, took up his post in 1997, every one of his annual budgets has included an array of tax breaks and other incentives for particular industries. Businessmen have been given prominent positions advising government, or even in it: Lord Simon, the former head of the BP oil giant, for example, or Lord Sainsbury, formerly of the eponymous retailer and now science minister, or Lord Haskins, who ran a task force dedicated to cutting red tape (his place has now been taken by another businessman, David Arculus). Labour should no longer be hostile to business, runs the party line; it should be friendly with it.

In France, close ties between senior businessmen and government have been endemic for decades, in part for corrupt reasons (as shown by the trial now under way of former executives of Elf-Aquitaine, an oil firm used for nefarious purposes by people close to the late François Mitterrand), in part because the line between civil servants, politicians and top managers is blurred—the same people move easily between the three roles.

In Germany, Gerhard Schröder has been cast in the part of rescuer of business, propping up the Holzmann construction firm, for example. Like his predecessors, he has maintained big subsidies to Germany's inefficient and heavily polluting brown-coal industry. He also employed a businessman to recommend changes to the country's labour laws: Peter Hartz, personnel director of Volkswagen. Helmut Kohl, Mr Schröder's predecessor as chancellor, made frequent visits to China, mainly with German businessmen to help secure them contracts. Japan has long had what is known as an "iron triangle" connecting big business, the bureaucracy and the ruling Liberal Democratic Party; and, as in the American Congress, Japanese parliamentarians develop expertise in particular areas of spending or regulation in order to attract corporate donations.

No one could easily overlook the representation of business in George Bush's White House, from John Snow, the treasury secretary, whose huge pay packets were mentioned earlier, to Donald Rumsfeld, the defence secretary, and Dick Cheney, the vice-president. The heads of the air force and navy were both recruited from defence firms despite—because of?—their huge budgets for procurement from those very firms. Of the 200 or so known members of Mr Bush's leading fund-raising group, known as "the pioneers", more than 40 have been given jobs in government. When Mr Cheney ran a task force to recommend changes in American energy policy, he naturally consulted a lot of big energy firms, most embarrassingly Enron. No doubt it was entirely coincidental that his report recommended subsidies and incentives to increase domestic output of energy—by American energy firms.

What can be and is easily overlooked is that the American government, despite its supposed reckless market-fundamentalism, actually spends more than \$90 billion of the federal budget each year on hand-outs to business: farm subsidies (which mainly go to agri-businesses, not farmers), research grants, export-credit guarantees, incentives of many kinds. Moreover, that figure, calculated by the Cato Institute, a Washington think-tank, is certain to be an under-estimate, as the true extent of what such critics call "corporate welfare" is not disclosed. Other rich countries do the same, especially for agri-businesses, but not only those. In 2000, export-credit guarantees outstanding from the 30 OECD members totalled \$330 billion.

American government spends more than \$90 billion of the federal budget each year on hand-outs to business

The interventionist itch

What is wrong with all this? Surely, now that it is agreed that socialism doesn't work and that direct government ownership is usually disastrous, politicians should work closely with businessmen? After all, they are the ones who know how to make things happen and to create jobs.

They are. But that is what, as far as possible, they should be left to do, in competition with one another and at arm's length from government. The job of a chief executive is to make profits for his company and, no doubt,

feather his own nest; it is not to make public policy—especially in his own industry, for that is where his selfish interests will be greatest. Inviting him to advise government, or listening to his views about promoting share options to help his industry, is sure to divert public policy to private ends. This is not the fault of executives or their companies; it is the fault of government.

Ministers and business bosses do, of course, share some goals: they both want faster economic growth, and they often both want jobs to be created or, in the common political parlance, "protected". So the urge to cooperate is powerful, by ministers acting as salesmen abroad or slanting regulations, tax breaks and subsidies to promote desired outcomes at home. It is not always corrupt or self-serving or distorting, and is often done with honourable motives. But it still ought to be avoided, for five main reasons.

The first is that, far more often than not, the outcome is bent to selfish ends. Adam Smith wrote in the 18th century that trade regulations "may, I think, be demonstrated to be in every case a common piece of dupery, by which the interest of the State and the nation is constantly sacrificed to some particular class of traders." The same applies to many regulatory and fiscal measures. Once established, such measures become perilously hard to change, for the beneficiaries fight to keep them.

The urge for business bosses and ministers to co-operate is powerful but ought to be avoided

The second is also shared with trade protection. It is that even if such intervention might be justified on some economic ground or other, governments do not have the knowledge or competence to be able to direct it properly, in terms of quantity, character and timing. That is why governments often end up seeking businesses' advice, which returns us to the previous problem.

Third, interventions are never neutral. Money or privileges are given to one group at the expense, directly or indirectly, of others or of taxpayers in general. Even within an industry, the interests of the firms consulted may differ from those of other firms. Efforts to even things up just add to the costs. And domestic interventions distort international competition just as much as do tariffs. One of the greatest achievements of the European Union has been to agree to limit and in many cases entirely forbid state subsidies in member countries, for exactly that reason. But the task is incomplete.

Fourth, all fiscal and regulatory interventions are an invitation not only for lobbying but also for outright corruption. That, it must be admitted, is why some politicians like them: they provide the leverage with which to extract political donations.

Fifth, and perhaps most fundamental, is the related fact that close ties between business and government are detrimental to democracy, and to public trust in democratic government. Companies pose a problem for democracy by their very existence, for through their command over resources, persuasive power and many legal privileges (such as the limited liability that is the basis of joint-stock companies), they unavoidably carry much more political weight than do individual citizens. Similarly, political equality is challenged by extremes of wealth, for with more money may come more political power. Both inequalities have to be tolerated because they bring social advantages too, but there are limits. In democracies, governments have to be the arbitrators, the counterweights to powerful private groups. But if they allow, or even encourage, companies and wealthy individuals to manipulate them, they risk stretching public faith in democracy to breaking point.

At least Sisyphus tried

Needless to say, governments will always deal with businesses. They will always want to, to some extent, and their taxes, spending and regulations will mean that they always have to. Individuals and companies will also always offer financial and other support to political parties, and will seek, on their own or in groups, to lobby governments in support of their interests. So, whereas entirely free trade may in principle be attainable (though it remains a distant prospect) because the bargaining in governments' trade deals could go all the way to zero, the complete detachment of governments from business, lobbies and donors is not.

Pushing back the extent of influence is destined to be a never-ending effort, particularly when the influence-taking gets out of hand, as it did in most rich countries (especially America) during the late 1990s. Competition

and choice are the market processes that bring long-term, broadly based benefits to the public, and political influence or favouritism constantly threaten to disable those processes.

There is no single, big solution to campaign-finance abuse, interest-group influence or corporate privileges. As Mr Rauch wrote in his 1999 book "Government's End", what is needed is a panoply of incremental changes: pressure to scrap corporate welfare; reforms to make tax systems neutral rather than preferential; more use of competitive contracts for public programmes to discourage their capture by particular interest groups; a stronger antitrust policy generally (this has been one of the bright spots in public policy in America, Britain and the EU as a whole in recent years); a more robust attitude by politicians to corporate pressure; more legal challenges to abuses of procedure; laws enforcing the disclosure of political donations and banning devious funding routes; laws seeking to reduce the need for campaign money by handing out free advertising time on television; and a myriad other measures.

Without that Sisyphean effort, governments will just be crushed. And so, eventually, will be the freedoms both of capitalism and democracy.







Give freedom a chance

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An agenda for rich-country governments

THESE are melancholy times, to borrow a word from James Wilson's 1843 essay that gave birth to *The Economist*. The world's big economies are growing sluggishly, if at all, with price deflation a fact in Japan, a fear in western Europe and a danger in the United States. The brightest economic lights, in China and the rest of East Asia, have just been dimmed by fear of a new respiratory disease, SARS. The two big driving forces of the past few years, technology investment and American domestic demand, both look unlikely to provide much new stimulus any time soon. Meanwhile arguments continue to rumble over the war in Iraq, optimism about peace in the Middle East is as rare there as lush green fields, even after George Bush's recent summit in Aqaba, and al-Qaeda's terrorists have again proved themselves capable of bringing death and fear.

Yet the pessimism is overdone. Some of it is the inevitable result of fear, especially of war and terrorism. Much, though, is caused by impatience. When a financial-market boom has been as extreme as the one that took place in the rich countries during the late 1990s, and is followed by a bust as extreme as the one that started in 2000, it always takes time for economies to adjust. Excess capacity built up during the boom has to be scrapped or somehow absorbed; corporate and consumer debtors have to cut their spending and increase their saving in order to avoid bankruptcy; and those who lost billions in the crash—mainly pension funds and life-insurance firms—have to come to terms with their new circumstances.

The good news is that, unlike in previous stockmarket crashes, there have been no commercial-bank collapses to deepen the recession. This means the losses have been spread widely among many investors, mainly in America and Europe, which has reduced the pain but will probably prolong it.

The other, even better news is that the crash and slowdown in growth have not so far set off a big retreat from liberalism. There have been steps in the wrong direction, notably America's steel tariffs and extra farm subsidies, and the European Union's decision to shy away from cutting its big, trade-distorting common agricultural policy. Thanks to depressed stockmarkets and worries about jobs, privatisation programmes have ground almost to a halt in the rich countries, and deregulation in over-rigid Germany and Japan is proving painfully slow. So far, though, the political debate is not about whether to do these things but when. And the pressure from the developing world, especially China, is arguing for sooner rather than later: fast growth there and continued liberalisation are intensifying competition for many firms and, on balance, reinforcing the case for deregulation and technological innovation in the rich world.

However, as long as this adjustment period lasts, the political climate for open markets will get icier in both Europe and America. Al Gore ran on an anti-business ticket in America's 2000 presidential election, in response to the perceived excesses of pay and profits during the 1990s, and had he been a competent campaigner he would surely have won. In 2004 any Democratic opponent of George Bush will make much of unemployment, tax cuts for the rich and the failure to deal decisively with corporate wrong-doing. Mr Bush might well be tempted to protect some more old industries against "unfair" competition, just as he already has for steel and farms, in order to lure his share of working-class votes. The same dynamic will apply to congressional races.

In Europe the idea that trade liberalisation does not help the poor and has led to growing inequality is already popular and could gain further ground. Tensions with America over Iraq, the Middle East and elsewhere have eroded the fragile support in continental Europe for what are seen as American policies of free markets and shareholder capitalism, as well as making it less likely that the EU will change its mind and agree to cut farm subsidies as part of a new round of trade negotiations in the WTO.

International politics add to that danger. The foreign policy that America has embarked upon since the atrocities of September 11th consists of a concerted attempt to solve some long-term problems inherited from the cold war and even the second world war, especially in the Middle East, which have helped make America the target of messianic terrorists. But since the solutions involve change, and change risks instability as well as conflict, that policy is causing widespread nervousness and even opposition among America's European allies. Some cackhanded American diplomacy and implementation of the policy (especially in Iraq immediately after the military victory) has not helped. Nor has an associated perception that the Americans are deserting the multilateral organisations they helped set up after 1945: the UN (over Iraq), and perhaps in future the WTO, given America's new liking for bilateral trade pacts.

The underpinnings of progress in the world remain strong, but the chillier political climate is putting that progress at risk. Some of what needs to be done to kick liberal capitalism back into acceptability has been outlined in this survey: moves to punish corporate wrong-doers and to fill the power vacuum that is leading executives to line their bank accounts; moves to separate business and government in order to preserve government's role as an arbitrator and counterweight, rather than as a corporate poodle. A wider and equally important hope is that politicians and policymakers will keep their eyes on the long-term, wealth-creating benefits of liberalism and avoid the temptations of subsidy and trade protection, which so often end up by eroding economic freedom gradually but powerfully.

The underpinnings of progress in the world remain strong, but the chillier political climate is putting that progress at risk

Hope seems a frail reed on which to rely. But there is strong evidence of the gains that liberalism brings, in terms of higher living standards and the reduction of poverty, providing ammunition for the constant and vigorous campaign that is needed if freedom is to be preserved and enhanced, and the hope fulfilled. That evidence is particularly convincing in the developing world, where Asian successes act as a fine example to others.

Where rich-country campaigners—and, even more important, rich-country governments—need to work harder is in distinguishing the real problems of the third world from those sweepingly claimed by anti-globalisation campaigners. Poverty is being reduced, thanks to globalisation, as is inequality; but neither is being reduced rapidly enough, and the process is leaving plenty of people behind. A right and proper task for liberals is to shine the light of hope on the un-globalised and un-developed parts of the world, which particularly means Africa. That is desirable in its own terms, but it would also help strengthen support for liberalism at home, which is sapped by the sight of unresolved, and in some cases worsening, poverty abroad, and the mistaken association of that in many people's minds with trade and freer markets.

The evidence from Asia suggests that the main solutions to African poverty lie in Africa itself, and particularly in its governmental institutions. Whatever the magic of markets, they cannot work effectively without the rule of law, the protection of property rights, stable and socially acceptable regulations, and stability of public finances and the national currency. Rich-country liberals can do little directly to provide those, beyond attaching incentives for their creation to overseas aid. They can, though, push for two big things which would give local activists for democracy and market capitalism in

The evidence from Asia suggests that the main solutions to African poverty lie in Africa itself

Africa a better chance of success.

The first would be to press governments to double—no, treble—the sums they are giving to help fight the diseases that are plaguing so much of Africa and undermining its social and political institutions. These are, principally, AIDS, malaria and tuberculosis. The United Nations has a "Global Fund" established to channel donors' money into research and treatment for those diseases, and the strengthening of health-care systems in afflicted countries more generally, in order to supplement and co-ordinate bilateral efforts.

The value of life

In total, more than 20m people have died from AIDS already. Some 2.4m Africans died from it last year alone, and nearly 30m Africans are thought to carry the virus that causes it. Each year about 2m people die from tuberculosis (some because they also have AIDS) and at least 1m from malaria. Given that toll, you would have thought that the necessary billions would be forthcoming. They have not been.

Bilateral aid for these diseases last year amounted to about \$1.2 billion. Rich-country governments have pledged a mere \$4.6 billion for the UN's Global Fund since it was established in 2001 as a six-year programme. Some of that is coming from the United States, as the multilateral part of a mainly bilateral \$15 billion effort expanded by President Bush in February and just confirmed by Congress, and about \$2.5 billion from the EU countries—which has been rising, to match America's effort. But all these amounts, welcome as they are, remain too small for the task.

There are plenty of good reasons to doubt that overseas aid has been effective in the third world. Much has been stolen or wasted. It seems to work only when it is well targeted and monitored by outsiders, and when it is not simply a substitute for local money. Dealing with these diseases fits all those bills.

If the European Union, Japan and the United States were to treble the combined sums they donate to the Global Fund and in bilateral disease-related aid to, say, \$15 billion a year, their taxpayers would have to stump up about \$30 per head. That does not seem a lot for saving millions of lives and shoring up crumbling societies. Nor is it much compared with the other things on which rich countries spend their money. America shells outs \$400 billion a year on defence, for instance. The 30 members of the OECD spend more than \$330 billion a year on supporting their farmers, both through direct subsidies and through higher prices for consumers. Cut that by 5%, and you will have found enough money to treble the rich world's current official donations to fight AIDS.

Farm support should, though, be cut by much more than 5%. Dismantling the EU's common agricultural policy, America's lavish system of farm support and Japan's protections for its domestic producers of rice and other foods is the second big thing

Overseas aid seems to work only when it is well targeted and monitored by outsiders, and when it is not simply a substitute for local money

that rich-country liberals must fight for in order to give market capitalism a chance in the poorest countries. Freeing farm trade is a wearying campaign, for it has gone on so long—160 years, indeed—and to so little effect. It is tempting to give up, accepting that lavish farm support is bound to remain a permanent feature of the developed world, and a continuing slap in the face to the farmers of Africa and the rest of the third world. That, however, would be a terrible mistake—a betrayal of the poor, in the rich countries as well as in Africa.

Making their garden grow

If farm subsidies and trade barriers were to be reduced and eventually eliminated, the biggest beneficiaries would be the developed countries themselves and especially their poorest citizens, for they spend more of their income on food than the rich do and so would gain most from lower food prices. They also suffer most from the worsening of food quality that has resulted as agriculture tries to cope with high prices, restricted trade and dear land by becoming ever more industrialised.

Farmers themselves would lose out if support were to be reduced, but mainly the bigger ones. In the EU, the

largest 25% of farms get 70% of the subsidies. The CAP is an inefficient way to bolster farm incomes anyway: nearly half of the cost to taxpayers and consumers is reckoned to go into higher rents or land values. And, before you start believing the popular argument that these inducements are needed for environmental reasons, think of the pollution from fertilisers and pesticides, the loss of wildlife habitats, the heavy use of water and the high energy bills for glasshouses, all of which result from the intensive agriculture that subsidies encourage in Europe, Japan and America.

Third-world farmers would gain from reduced farm support in rich countries because new markets would open up for their produce. European farm ministers try to deny this by claiming that African produce does not compete with that of European farmers, but that is, as it were, a chicken-and-egg issue: African farmers do not compete with European ones because high tariffs and low quotas prevent them from doing so. What they would gain most of all from the opening up of agricultural trade would be choice, the chance to try to grow and sell new crops or livestock. Third-world food-processing businesses would also benefit, for the tariffs on processed food are often even higher than on the unprocessed sort.

Third-world farmers would gain from reduced farm support in rich countries because new markets would open up for their produce

Coffee producers, for example, are currently suffering from a big slump in prices, thanks to rapid increases in production in Vietnam and elsewhere. If more coffee

farmers had the option to switch to other foods and crops that are currently protected in the rich world, or to move upmarket by processing more of their crop, the slump could be dealt with. Mike Moore, the New Zealander who has just retired as director-general of the WTO, writes of another example, cotton, in his new book, "A World Without Walls". In 2001, American cotton producers received \$3.4 billion in government subsidies, which went to a total of 25,000 farmers whose net household worth averaged about \$800,000. The IMF and the World Bank reckon that removal of those American subsidies would increase the incomes of cotton-producing countries in West and Central Africa by \$250m a year.

Complete liberalisation in agriculture is a remote prospect. But the process can be started, just as it has been in other sectors during the past half-century. It is supposed to be at the centre of the current Doha round of trade negotiations. Getting the process of freeing farm trade under way should become one of the great campaigns for liberals during this decade, just as the corn laws were in the early years of *The Economist*. In his polemical prospectus for his new free-trade publication in the summer of 1843, 160 years ago, James Wilson ended with these words:

And we hope to see the day when it will be as difficult to understand how an act of parliament could have been made to restrict the food and employment of the people, as it is now to conceive how the mild, inoffensive spirit of Christianity could ever have been converted into the plea of persecution and martyrdom, or how poor old wrinkled women, with a little eccentricity, were burned by our forefathers for witchcraft.

Here's still hoping.





Sources and acknowledgments

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